No. [illegible]

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

[illegible] Clark and Faye Clark,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

On Petition for Review of the Decision of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

FILED

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No. 16010

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Gene O. Clark and Faye Clark,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

On Petition for Review of the Decision of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

Opinion Below.

The Findings of Fact and Opinion of the Tax Court are shown in the record at pages 52 to 145 and are designated by the Tax Court as T. C. Memo. 1957-129.

Jurisdiction.

This proceeding involves asserted deficiencies in income taxes for the taxable years 1946 and 1947.

On May 18, 1953 [R. 3], under provisions of Section 272 of the Internal Revenue Code of 1939, the petitioners filed with the Tax Court petitions for redetermination of additional taxes proposed against them on February 20, 1953 [R. 6, 7].

The decision of the Tax Court was entered November 20, 1957 [R. 5]. The case was brought to this Court by Petition for Review filed by the petitioners, Gene O. Clark and Faye Clark, on February 10, 1958 [R. 5]. The jurisdiction of this Court is based on Section 7482(a) of the Internal Revenue Code of 1954 (Sec. 1141(a) of the Int. Rev. Code of 1939 as amended).

Statutes and Regulations Involved.

The applicable statutes and regulations are set forth in the Appendix, *infra*.

Statement of the Case and Questions Presented.

This controversy involves the determination of the income tax liability of Gene O. Clark for the taxable years 1946 and 1947 and the determination of the income tax liability of Faye Clark, his wife, for the year 1947. Separate returns were filed each year by the taxpayers, on income derived from community sources. The Petitioners resided in the State of California during the period here involved.

Gene Clark and his wife, Faye Clark, owned as their community property 70 per cent of the stock of Gene Clark, Inc., a California corporation. This corporation was organized on May 1, 1946, and was on the accrual basis of accounting. Its fiscal year ended on April 30th of each year.

The Commissioner of Internal Revenue determined that Gene Clark, Inc., received taxable income which it failed to report on its returns. He further determined that certain amounts of this alleged unreported corporate income was received by Petitioners as "constructive dividends" during the years 1946 and 1947.

The Tax Court found, without affirmative pleadings on Respondent's part, that Petitioners received more income than was determined by Respondent in his deficiency notices.

Petitioners contend that any unreported corporate income was used for corporate purposes and was not diverted to their own benefit; that Respondent's determinations were arbitrary, capricious, erroneous and invalid; and further, even assuming Respondent's determination of unreported corporate income was correct, there were insufficient earnings and profits available for distribution from Gene Clark, Inc., to cause a distribution thereof, to be ordinary dividends to Petitioners.

Petitioners also contend they cannot now be taxable on income Respondent determined they did not receive.

The principal questions presented are: (1) whether the record of this case supports a finding that Petitioners received "constructive dividends" from Gene Clark, Inc., which they failed to report on their individual tax returns for 1946 and 1947, and, if so, in what amounts; (2) whether Petitioner Gene O. Clark filed fraudulent tax returns for the years 1946 and 1947; (3) whether assessment and collection of any of the deficiencies that may be determined against Petitioner Gene O. Clark for 1946 and 1947 are barred by the Statute of Limitations; (4) whether assessment and collection of any deficiencies that may be determined against Petitioner Faye Clark for 1947 are barred by the Statute of Limitations; and (5) whether the Tax Court was correct in holding that more income than was asserted in Respondent's deficiency notices is taxable to Petitioners?

Specification of Errors.

I.

The Tax Court erred in holding and finding that Petitioners did not sustain their burden of proof for each of the years 1946 and 1947 [R. 84-86].

II.

The Tax Court erred by increasing Petitioners' income beyond the amounts determined in Respondent's deficiency notices [R. 97-99, 122-124].

III.

The Tax Court erred in failing to accrue and deduct taxes, penalties and interest in determining earnings and profits available for distribution to Petitioners from Gene Clark, Inc., at the close of its fiscal year 1948.

IV.

The Tax Court erred in determining that $74,984.96 was available for distribution and was in fact distributed to its stockholders out of the alleged earnings and profits of Gene Clark, Inc., for its fiscal year ending April 30, 1947 [R. 93].

V.

The Tax Court erred in determining that $85,827.47 was available for distribution and was in fact distributed to its stockholders out of the alleged earnings and profits of Gene Clark, Inc., for its fiscal year ending April 30, 1948 [R. 123].

VI.

The Tax Court erred in determining that $44,227.13 was distributed to Petitioners in the calendar year 1946 [R. 106].

VII.

The Tax Court erred in determining that $45,028.91 was distributed to Petitioners in the calendar year 1947 [R. 123].

(a) The Tax Court erred in its failure to find that out of the alleged earnings and profits of Gene Clark, Inc., $77,207.15 could not possibly be distributed to its stockholders in 1947.

VIII.

The Tax Court erred in finding that loans by Gene Clark, Inc., in the amount of $36,149.29 to its stockholders were disguised dividends [R. 77].

IX.

The Tax Court erred in holding and finding that Petitioner Gene O. Clark filed false and fraudulent income tax returns for the years 1946 and 1947, and that a part of the deficiency for each of said years was due to fraud with intent to evade taxes [R. 140, 142].

X.

The Tax Court erred in finding that any deficiencies against Petitioner Gene O. Clark was not barred by the Statute of Limitations for the years 1946 and 1947, and that any deficiencies against Petitioner Faye Clark was not barred by the Statute of Limitations for the year 1947 [R. 142-144].

Summary of Argument.

I.

The Petitioners demonstrated that Respondent's deficiency notices, on their face, were arbitrary and erroneous. The Tax Court recognized this and yet treated such notices as if they were evidence in order to find deficiencies against Petitioners.

II.

The Tax Court cannot support a deficiency assessment by accepting new matter which was surprisingly brought out for the first time in Respondent's Brief, especially where such new matter is inconsistent with Respondent's own determination, and there were no affirmative pleadings on his part.

III.

The Tax Court in determining earnings and profits available for distribution from Gene Clark, Inc., after correctly accruing Federal taxes of the corporation for its fiscal year ending April 30, 1947, erroneously abandoned this concept and failed to accrue taxes of the corporation for its fiscal year ending April 30, 1948. The Tax Court also neglected to accrue fraud penalties set up against the corporation for the year 1947 and interest on the deficiencies set up against the corporation for the year 1947 for its fiscal year ending April 30, 1948.

The propriety of accruing all of such items, taxes, fraud penalties and interest, is well accepted in the law when a determination of earnings and profits available for distribution is being made.

IV.

The evidence and the entire record of this case, including Respondent's deficiency notices and Revenue Agent's Reports, does not support the findings of income to Petitioners in the amounts attributed to them by the Tax Court.

V.

The Tax Court cannot disregard uncontradicted testimony and the books and records of Gene Clark, Inc., in making a finding that a loan of the corporation to its officers was instead a dividend.

VI.

There was absolutely no proof that Petitioner Gene O. Clark received and retained unreported income. The Tax Court, nevertheless, by entertaining mere suspicions, found that the Respondent had met his burden to prove fraud by clear and convincing proof.

VII.

The Statute of Limitations bars any deficiency against Petitioner Gene O. Clark for the years 1946 and 1947; and the Statute of Limitations bars any deficiency against Petitioner Faye Clark for the year 1947.

I.

The Deficiency Notices of the Commissioner Are Arbitrary, Capricious and Erroneous on Their Face. The Determinations Contained Therein Cannot Be Used as Evidence Against Petitioners.

The basis of the Respondent's determination of the tax deficiencies against the Petitioners is contained in the reports of the Revenue Agent respecting the individuals and Gene Clark, Inc., a California corporation. It was stipulated at the trial of these cases that the deficiency notices were based upon the Revenue Agent's Reports [R. 84].

All of the additional income in dispute set up against the Petitioners was alleged to have come from Gene Clark, Inc., through "constructive dividends" [R. 10 and 30].

The investigating agent testified that as used in his reports the term "constructive dividends" meant moneys and property available to the stockholders of the corporation that they had taken for their own uses [R. 475]. During the periods here involved Petitioners owned 70 per cent of the stock and one Archie Koyl and his wife owned 30 per cent of the stock of Gene Clark, Inc.

The Revenue Agent was unable to trace any of the alleged "constructive dividends" to Gene Clark or his wife Faye [R. 471]. Instead, he used what he referred to as the formula method [R. 456]. Pursuant to such formula, he arbitrarily distributed 70 per cent of the alleged "constructive dividends" to Petitioners and 30 per cent to Archie Koyl and his wife [Ex. 3-C].

The attribution of 70 per cent of the alleged additional income of Gene Clark, Inc., to Petitioners was completely unsubstantiated by the agent's investigation. He never talked to Petitioners [R. 305]; was not able to trace any

corporate income, reported or unreported, into Petitioners' personal bank accounts [R. 315]; nor did he complete a computation of Petitioner's net worth [R. 313-314].

The fiscal year of Gene Clark, Inc., ended April 30 of each year. The agent, therefore, had to ascertain what amounts of the alleged earnings and profits were properly allocable to the individuals' calendar years as constructive dividend distributions. Without regard to the dates the transactions took place, the agent arbitrarily allocated 84.259 per cent of the corporate earnings available for distribution for the fiscal year ending April 30, 1947, to the stockholders as income to them in 1946, and 15.741 per cent as income to them in 1947. When asked on cross-examination how he arrived at this allocation, the agent could not explain it [R. 305, 306].

The same unexplainable arbitrary method was used to distribute the available earnings and profits of Gene Clark, Inc., for its fiscal year ending April 30, 1948, only this time the agent attributed 41.523 per cent as income to the stockholders in the year 1947, and 58.477 per cent to them in the calendar year 1948. As above mentioned, 70 per cent of these amounts allocated to each of the calendar years was treated as income of Petitioners. The Revenue Agent's Report [Ex. 3-C], itself shows that out of $149,-233.83 of earnings and profits available for distribution, $77,207.15 were 1948 transactions. Exhibit F attached to the appendix of this brief for the convenience of the Court, summarizes these 1948 items.

It is manifest from the foregoing that the Agent's report is arbitrary, contradictory and erroneous on its face.

The Tax Court, however, found the methods used by the Respondent to be reasonable and adopted his formula as

to the fiscal year 1947 [R. 106, 107]. As to the fiscal year ending April 30, 1948, the Tax Court abandoned the Respondent's formula method and after making certain adjustments for the allowance of deductions for accommodation checks [R. 117] and duplicated items [R. 115], attributed all the earnings and profits of the corporation (without regard to items the Respondent found were not available) to the stockholders' calendar year 1947 [R. 124]. No attention was paid to the fact that the Agent's report itself showed $77,207.15 as taxable events occurring in the year 1948 [see Ex. F attached in the appendix].

It is submitted that it is readily apparent from the foregoing, the finding of the Tax Court in regard to both the calendar years 1946 and 1947 was clearly erroneous.

The lower Court has at the same time used the Revenue Agent's Report as evidence of the amounts of income and rejected other findings of the Respondent, without regard to the pleadings or record in the case. It is incongruous that the Tax Court would accept any part of the Revenue Agent's Report as evidence after it commented during the trial that it was "a calculation that everybody agrees is wrong and has agreed was wrong right straight through" [R. 187].

Substituted Deposits.

One of the principal theories of the Respondent, for setting up additional income to the corporation, was that since Gene Clark, Inc.'s cash receipts records did not always correspond exactly item for item with those amounts deposited in the corporation's bank accounts, for every deposit made that did not precisely equal the amount shown in the cash receipts record, there must have been a like amount withheld by the stockholders of Gene Clark, Inc. [R. 448].

The facts show that every item set out by the Revenue Agent as being a substitution was instead reported by the corporation. The agent admitted on cross-examination [R. 457] that the deposits made in the corporation's bank accounts totalled the exact amount of the items set forth in the revenue agent's report of the corporation, as not being reported.

He further testified [R. 458] that all of the items set forth in the revenue agent's report designated as "substituted" were deposited in the corporation's bank account; that every one of the items denominated as "substituted" were picked up from the corporation's records; that the bank account of the corporation was fully presented in the return filed by the corporation [R. 460, 461]; that the corporation's tax returns show a reconciliation with the books [R. 471]; that included in the reconciliation with the books is the reconciliation with the corporation's bank account, and included in the corporation's bank account are the items set forth as being "substituted" [R. 471, 472].

The items set up by the Revenue Agent as being "substituted" are found on the pages of Exhibit 3-C as follows:

Year	Pages of Exhibit 3-C	Amount
April 30, 1947	46 to 55, incl.	$14,806.77
April 30, 1948	59 to 66, incl.	49,147.27

The record revealed that Gene Clark, Inc., made a practice of cashing accommodation checks for employees of various business establishments at or near its business location [R. 269]. There was, therefore, a reason for the variance in exact amounts of bank deposits and the cash receipts book. This necessarily bred wide room for error on Respondent's part in the determination of sales, where the corporation ran such checks through its bank account.

(*Bonnie Gladys Gray, et al.* (1953) P-H Memo. T. C. ¶53,000.) The Tax Court recognized this fact but chose to allow a fractional reduction in the alleged unreported sales, instead of throwing out Respondent's determination [R. 117].

Although the lower court applied the "Cohan rule" (see *Cohan v. Commissioner* (2d Cir., 1930), 39 F. 2d 540), to reduce the sales derived from so-called substituted deposits, because of the corporate practice of cashing accommodation checks, it would not apply the *Cohan* rule to allow a further reduction in any amount by reason of money expended for purchases made by Gene Clark [R. 88, 89]. The court found the petitioner Gene Clark had made purchases of the goods which were alleged to be sold and unreported, yet gave credit for none, and applied tax to the gross receipts of such alleged sales. This resulted in a finding contrary to well established practice in tax cases of estimating the expenses where books and records are lacking. An estimate could have been very easily reached by looking to the corporation's tax returns to ascertain the average cost of goods sold and net profit derived from sales.

The lower Court not only accepted as a fact that the amounts deposited and reported were a valid measure for determining a like amount of unreported income [R. 87] but found that 70 per cent of such amounts were distributed to the Petitioners. There was absolutely no evidence introduced to show Petitioners received and retained for their own enjoyment any of such alleged income.

Petitioner Gene Clark testified that whenever he cashed checks belonging to the corporation, such moneys were used to purchase materials for the business, and the cor-

poration eventually ended up with the benefits of all the transactions [R. 330-332, 393].

This testimony was corroborated by the Respondent's witness Frederick Files [R. 266 to 268]. The Tax Court chose to disbelieve this uncontradicted testimony and found not only that Petitioners received 70 per cent of the amount Respondent determined in his deficiency notices was income to them, but that they had in fact received all of the earnings and profits of Gene Clark, Inc., which were set up by the Respondent in the Revenue Agent's Report of Gene Clark, Inc.

Applicable Law.

Where a deficiency notice is based upon an agent's report which does not verify the entire income and which does not show logical reason for arbitrary adjustments, it should be disregarded. *Bruce & Human Drug Co.* (1925), 1 B. T. A. 342; *Alcorn Refining Co.* (1925), 2 B. T. A. 253; *Index Norton Co.* (1925), 3 B. T. A. 90; *Schlemmer & Garber Co.* (1925), 2 B. T. A. 823.

In *Bruce & Human Drug Co., supra,* the agent failed to verify the entire income, either by an examination of all the income and expenses, or by a proof of the opening and closing balance sheets of the taxpayer. Under such circumstances, the Board held for the taxpayer, on the basis that the deficiency notices should be disregarded.

In the instant case, the Agent did not verify the income he set up by way of net worth [R. 313, 314] statements, bank deposit analysis [R. 315], nor did he reconcile his findings as to earnings and profits with opening and closing balance sheets. When asked on cross-examination why he did not use balance sheets, he declared that he was not required to [R. 309, 310].

Petitioners demonstrated, through expert testimony of Paris B. Claypoole [R. 179 to 207] that the deficiency notices were mathematically wrong and legally erroneous in that sound accounting principles were not followed [Exs. 15, 16, 17 and 18]. The Respondent introduced no evidence to show Petitioners' expert was incorrect.

It has been held that where the Tax Court has no other evidence relating to a fact, it cannot disregard credible expert testimony where there was no evidence rebutting such expert testimony. *Belridge Oil v. Commissioner* (9th Cir., 1936), 85 F. 2d 762; *Royal Highlands v. Commissioner* (8th Cir., 1943), 138 F. 2d 240.

While there is a presumption that the Commissioner's findings are correct, when it appears, as in this record it does appear, that the methods pursued by the Commissioner were mathematically and legally erroneous, that presumption no longer avails. *Russell v. Commissioner* (1st Cir., 1930), 45 F. 2d 100.

Petitioners believe that it is evident they sustained their burden and clearly demonstrated the deficiency notices were arbitrary and erroneous on their face.

It must be borne in mind that this case involves a determination of gross income. The Supreme Court in the leading case of *Helvering v. Taylor* (1935), 293 U. S. 507, stated that although the burden is upon the taxpayer to establish the amount of a deduction claimed, when determining gross income all the taxpayer must do is show that the Commissioner's determination was arbitrary and wrong to have it set aside. The taxpayer need not also show the correct amount of income. Judge Learned Hand in the Circuit Court decision of the same case, which was affirmed by the Supreme Court, *Taylor v. Commissioner,*

70 F. 2d 619, pointed out at page 621 that in cases involving the determination of gross income, the taxpayer need not prove a negative—disproving the existence of all possible obligations.

The principles laid down in *Helvering v. Taylor, supra,* have been consistently followed. From the multitude of cases that follow the Supreme Court decision, the following are most in point in the instant case: *Gasper v. Commissioner* (6th Cir., 1955), 225 F. 2d 287; *Bryant Heater v. Commissioner* (6th Cir., 1957), 248 F. 2d 939; *Simon v. Commissioner* (8th Cir., 1957), 248 F. 2d 874; *Estate of Belyea v. Commissioner* (3rd Cir., 1953), 206 F. 2d 266; *Federal National Bank of Shawnee, Oklahoma v. Commissioner* (10th Cir., 1950), 180 F. 2d 494; *Durkee v. Commissioner* (6th Cir., 1947), 162 F. 2d 184; *Industrial Trust Co. v. Commissioner* (1st Cir., 1947), 165 F. 2d 142; 1 A. L. R. 2d 144; *Worchester County Trust Co. v. Commissioner* (1st Cir., 1943), 134 F. 2d 578, 580; *Hemphill Schools v. Commissioner* (9th Cir., 1943), 137 F. 2d 961; *J. M. Perry v. Commissioner* (9th Cir., 1941), 120 F. 2d 123; *cf. Showell v. Commissioner* (9th Cir., 1956), 238 F. 2d 148.

The statement of the Court in *Gasper v. Commissioner, supra,* at page 288 is particularly appropriate:

> "In the light of Helvering v. Taylor, supra, and Durkee v. Commissioner, supra, the Commissioner's determination in the instant case should be set aside since any presumption in its favor disappears once the determination has been proved incorrect; and there is no burden upon the taxpayer to show what the correct amount of the deficiency should have been."

Also see the dissenting opinion of Judge Pope in *Showell v. Commissioner, supra,* at page 154.

During the trial of this case, it became manifest through the cross-examination of Revenue Agent Phillips, that the deficiency notices were mathematically erroneous and such determinations were based upon an arbitrary formula, without any sort of verification. At no time was the Respondent able to explain how he arrived at his allocation of income between years.

Petitioners introduced into evidence, through their expert, Exhibits showing the determinations to be wrong [Exs. 15, 16, 17, 18] on their face. This evidence was not challenged. Petitioner Gene O. Clark's testimony, which was corroborated by Respondent's witness Fred Files, was not contradicted.

The deficiency notices having been shown to be arbitrary and erroneous and evidence having been so produced, the presumption in favor of the Respondent's determination ceased to exist. Thereafter the case depended wholly upon the evidence. Instead, the Tax Court treated the determinations of Respondent as evidence. Under the principles enunciated by this Court in *Hemphill Schools v. Commissioner, supra,* and *J. M. Perry & Co. v. Commissioner, supra,* the Tax Court acted in a clearly erroneous manner.

II.

The Tax Court, Without Any Substantiating Evidence and Without Affirmative Pleadings on the Respondent's Part, Added More Income Than Was Asserted in Respondent's Deficiency Notices, to Petitioners' Income for the Calendar Years 1946 and 1947.

The Petitioners came into the trial of this case prepared to assail a deficiency based upon alleged additional income due to asserted constructive dividends received from Gene Clark, Inc., a California corporation. The deficiency notices [R. 10 and 30] themselves were sketchy. However, the parties stipulated [R. 84] that the deficiency notices were based upon the Revenue Agent's Report (hereinafter referred to as RAR) of Gene Clark, Inc. [Ex. 3-C].

The Respondent in this report (RAR) determined that Gene Clark, Inc. had an additional net income of $102,-050.17 for the fiscal year ending April 30, 1947, by reason of certain adjustments to deductions and increases in sales. He next determined that the two stockholders and their wives received some of this additional income of the corporation by way of constructive dividends. Recognizing that dividends can only come from available earnings and profits of the corporation (Sec. 115(a) U. S. C. A., Title 26 (1939 Ed.)) it was determined that the income reported on the corporation's return in the amount of $30,632.10 and other items totaling $63,488.47 was not available for distribution, or distributed, out of

the net income of Gene Clark, Inc. for its fiscal year ending April 30, 1947.

Similarly, as to the fiscal year ending April 30, 1948, the Respondent determined that the income reported on the corporation's return in the amount of $16,726.40, and other items totaling $6,381.15 was not available for distribution, or distributed, to the stockholders of Gene Clark, Inc.

The investigating revenue agent when cross-examined during the trial conceded that the amounts referred to above should not be considered available earnings to the Petitioners [R. 311, 312].

At no time during the trial was there any indication on Respondent's part that he was changing his position and claiming that said amounts represented additional income to these Petitioner stockholders. There was no evidence introduced at the trial which would substantiate a finding that these additional sums of income were received by the Petitioners. The first time the Petitioners were aware more income than was set up in the deficiency notices was being impressed upon them was when the Respondent made such an assertion in his brief.

Notwithstanding the fact the corporation RAR manifested certain amounts of alleged corporate income were not available for distribution and the individual deficiency notices did not include such amounts as income, and the examining agent concluded and testified he had found such items as not being available for distribution, and the taxpayers' expert witness, Paris B. Claypoole, testified that under sound accounting principles such amounts could not have been either available for distribution, or, in fact, distributed [R. 194, 195, 198, 199, 209] the Tax Court

found without one scintilla of evidence to substantiate such a finding, or any basis in legal reasoning, that the amounts were not only distributable, but were in fact distributed to the stockholders. [R. 97-99, 122-124].

In a case where a similar situation occurred, Chief Judge Murdock stated in *Vincent C. Campbell, et al. v. Commissioner* (1948), 11 T. C. 510, 511:

> "The Commissioner in his brief attempts to argue matters inconsistent with his own determination as disclosed in the deficiency notices. He may not do that under the rules of this Court without affirmative pleadings on his part. . . . The petitioners have properly deemed those matters not in dispute."

Under the Rules of the Tax Court, Rules 14 and 32, the burden of proof is on the Commissioner as to any new matter affirmatively pleaded in his Answer. Certainly, the Respondent cannot escape this burden by merely making new allegations in his brief.

In this case, one important point should not be lost sight of, and that is—even though the amounts in question under sound tax accounting methods were available for distribution (which is not admitted), it does not follow that any of said sums were distributed to Petitioners. The record is completely devoid of evidence for the Respondent in this regard.

In attacking the deficiencies set out in his own notice, Respondent assumed the burden of proving affirmatively the new postion upon which he relied, and in the absence of such proof, the Court was left only to consider the Petitioners' attack upon the original determination. *Fred Wolferman* (1928), 10 B. T. A. 285; Also see: *Sheldon Tauber v. Commissioner* (1955), 24 T. C. 129; *Cedar*

Valley Distillery, Inc. (1951), 16 T. C. 870; *Tex.-Penn. Oil Co. v. Commissioner* (3rd Cir., 1936), 83 F. 2d 518, 524, Aff'd 300 U. S. 481 (1937).

The Tax Court in the instant case erred in failing to abide by the concessions of the Commissioner in his deficiency notices. The finding by the Commissioner that certain amounts were not available for distribution together with the uncontradicted testimony of his own witness, Revenue Agent Phillips, removed any issue from the case as to whether said amounts were available or in fact distributed. In this regard, see *Lenox Clothes Ships, Inc. v. Commissioner* (6th Cir., 1943), 139 F. 2d 56, 60.

The Petitioners are under no obligation to support by evidence matters not set up by the Commissioner in his deficiency notice. *Harbor Plywood Corp. v. Commissioner* (9th Cir., 1944), 143 F. 2d 780. The Court stated (at p. 783):

> "This Court will not consider in support of a deficiency assessment, reasons not advanced by the Commissioner in his deficiency notice or before the Board of Tax Appeals, especially when the taxpayer has been deprived thereby of the opportunity to present evidence material thereto."

Judge Learned Hand observed in the famous case of *Taylor v. Commissioner,* 70 F. 2d 619, 621, aff'd *Helvering v. Taylor* (1935), 293 U. S. 507.

> "The original assessment rested upon a finding, presumptively correct, but the presumption does not extend to other findings which the Commissioner has never made."

III.

The Tax Court Failed to Properly Accrue and Deduct Taxes, Penalties and Interest in Determining Earnings and Profits Available for Distribution.

Gene Clark, Inc., a California corporation, was on the accrual basis of accounting [Exs. 12L, 13M] during the period here involved. Its fiscal year ended April 30th of each year.

The Respondent determined that Petitioners, who owned 70 per cent of said corporation's stock, received from it, constructive dividends which were not reported on their income tax returns during their calendar years 1946 and 1947. Since, as previously stated, dividends are only payable out of the earnings and profits of a corporation (Sec. 115(a), U. S. C. A., Title 26 (1939 Ed.)), it is necessary in determining what is available for distribution, to ascertain the proper charges to be made to the net income of the corporation.

The Respondent erroneously failed to deduct the accrued corporate income taxes which he found to be $50,419.26 from the $38,561.70 net earnings and profits available for distribution. If he had done so, nothing would have been available for distribution, as the corporation would have a $11,857.56 surplus deficit. Any distribution to the stockholders would, therefore, necessarily have to come out of capital (Sec. 115(b), U. S. C. A., Title 26 (1939 Ed.)). Petitioners' Exhibit 15 gives a clear picture of this situation in schedule form.

The Respondent also fell into the same error in determining earnings and profits available for distribution from Gene Clark, Inc.'s net income in its fiscal year 1948. Here, however, he not only failed to deduct corporate

income taxes, but failed to deduct accrued fraud penalties and accrued interest on the deficiencies he set up for fiscal 1947.

The Tax Court, in this case, recognized that accrued taxes should have been deducted from the amounts available for distribution for the corporation's fiscal year ending April 30, 1947 [R. 91, 93], but through the use of unsound mental gymnastics failed to accrue the taxes for Gene Clark, Inc. for its fiscal year ending April 30, 1948 [R. 121-124]. The Court also failed to deduct accrued fraud penalties and interest on the deficiencies set up against the corporation for fiscal 1947, in determining earnings and profits for the corporation's fiscal year ending April 30, 1948.

It is well established that in determining earnings and profits available for distribution (as distinguished from finding net income of a corporation) for an accrual basis corporation, that taxes must be deducted in the fiscal year they are due, *Stern Bros. & Co. v. Commissioner,* 16 T. C. 295; *Estate of Stein v. Commissioner,* 25 T. C. 940; *American Enka Corporation v. Commissioner,* 30 T. C. No. 65; *F. W. Drybrough v. Commissioner* (6th Cir., 1956), 238 F. 2d 735; *Commissioner v. Pacific Affiliate* (9th Cir., 1955), 224 F. 2d 578, aff'g 18 T. C. 1175, cert. den. 350 U. S. 967, that fraud penalties must be deducted in the year they accrue (*i.e.,* when the return is filed which is normally in the year after the taxes are due, *Estate of Stein v. Commissioner,* 25 T. C. 940, acq., Rev. Rule. 57-332, I. R. B. 1957-29, 8; and that interest is accruable and deductible annually from the due date of filing the return, *Sidney Stark, et al. v. Commissioner* (1957), 29 T. C. No. 17.

IV.

Based Upon the Record in This Case the Maximum Amount of Income Arising From "Constructive Dividends" of Gene Clark, Inc. to Petitioner Gene Clark Would Be Only $4,706.78 for the Calendar Year 1946, and $953.66 for the Calendar Year 1947. The Maximum Amount of Such Income to Petitioner Faye Clark Would Be $953.66 for the Calendar Year 1947.

1946

As previously discussed, the Tax Court added $63,-488.47 to the amount Respondent claimed was available for distribution out of the earnings and profits of Gene Clark, Inc. for its fiscal year ending April 30, 1947. The Court then determined that all of these amounts were distributed to the stockholders of Gene Clark, Inc. One of the items included in this amount of $63,488.47 was an alleged $6,000.00 "paper profit" arising from the purchase of a small tract house by Gene Clark, Inc. from one Truman Johnson [R. 94].

The house was held by the corporation until July 31, 1947, at which time it was sold to Petitioner Gene Clark for $18,862.10, which was the corporation's cost as reflected on its books [Ex. "KK"]. Notwithstanding these facts, the Court found that 84.259 per cent of the $6,-000.00 was in fact distributed to the stockholders Gene Clark and Archie Koyl on a 70/30 per cent basis, respectively, in the year 1946. The most that could have been considered a constructive dividend to the stockholders would have been the fair rental value of said home.

Another item making up the amount the Respondent determined was unavailable for distribution, but which the Court found was available and in fact distributed, was the

disallowance of a bad debt deduction in the amount of $3,703.50 [R. 96]. Petitioners are at a loss to see how this item could possibly be distributed to them, at all.

An examination of the balance sheet of Gene Clark, Inc. at April 30, 1947, which is attached in the Appendix hereof as Exhibit "B", reveals that the other items set up by the Respondent as not being available for distribution were not in fact available or distributed as they are clearly reflected in the balance sheet of the corporation.

In order to aid the Court in its review of this case, Petitioners have attached in the Appendix of this Brief the balance sheet of Gene Clark, Inc. at its inception, May 1, 1946 [which is attached as Ex. "A" hereto], the balance sheet of Gene Clark, Inc. at the end of its first fiscal year, which ended April 30, 1947 [which is attached as Ex. "B" hereto], and the balance sheet of Gene Clark, Inc. at April 30, 1948 [which is attached as Ex. "C" hereto]. These balance sheets are based upon the tax returns of said corporation, as adjusted by additions and concessions of Respondent in his Revenue Agent's Report [Ex. 3-C].

Assuming that Petitioners did not sustain their burden of proof, an examination of the record as it now stands reveals that the maximum amount of earnings and profits available for distribution out of Gene Clark, Inc. for its fiscal year ending April 30, 1947 was $15,960.25. This amount was arrived at by accepting the findings of the Tax Court as to earnings and profits available for distribution [R. 91] and deducting therefrom accrued Federal income taxes and the items Respondent conceded in his Revenue Agent's Report [Ex. 3-C] were not available for distribution (said amounts not having been added to Petitioners' alleged unreported income in the deficiency notices). A

clear picture of Petitioners' contentions is contained in Exhibit "D", which is attached to the Appendix of this Brief.

1947

Again assuming that Petitioners did not sustain their burden of proof, an examination of the record reveals the maximum amount of earnings and profits available for distribution to Petitioners for the calendar year 1947 from Gene Clark, Inc. for its fiscal year ending April 30, 1948 was $511.59. This conclusion is set forth in Exhibit "E" in schedule form, attached to the Appendix hereto. This amount was arrived at by accepting the findings of the Tax Court as to earnings and profits available for distribution [R. 122] and adding thereto the amount of $63,448.47, which is the amount the Respondent claimed, and Petitioners accepted, as not being available for distribution from Gene Clark, Inc. in its fiscal year 1947. From this total amount, we have deducted the accrued taxes, penalties and interest, together with an actual dividend which was declared in 1948, and the amount Respondent conceded was not available for distribution at the close of the corporation's 1948 fiscal year (said amount not having been added to Petitioners' alleged unreported income in the deficiency notices).

In determining what amounts of the earnings and profits of the corporation could have been distributed to the stockholders in their calendar year 1947 and what amounts could have been distributed to them in 1948, it is necessary of course, to ascertain when the corporate transactions took place. The Revenue Agent's Report [Ex. 3-C] reveals that out of such earnings and profits $77,207.15 were transactions which occurred between January 1, 1948

and April 30, 1948. This amount was asserted by the Respondent to be additional income of the corporation in its fiscal year ending April 30, 1948. Exhibit "F" is attached to the Appendix of this Brief for the convenience of the Court. It is a list of these 1948 transactions, as taken from the Respondent's Revenue Agent's Report [Ex. 3-C].

It should be clear that this amount could not possibly have been available for distribution in 1947, let alone be distributed to the stockholders of Gene Clark, Inc. in such year. The amount of $77,207.15 should, therefore, also be deducted from the earnings and profits of the corporation as determined by the Court, prior to any arbitrary allocation of income to the year 1947.

The Tax Court, after a carte blanche acceptance of portions of the Revenue Agent's Report, without substantiating evidence, has overlooked the 1948 transactions set forth in Exhibit 3-C, and has somehow concluded that $45,028.91 was distributed to the stockholders in 1947 [R. 123]. There was no showing that Petitioners received actual distributions from constructive dividends in any amount for the years involved. The lower Court, however [R. 122-124, incl.], keeps referring to *actual* distributions of $85,827.47 and then completely abandons the allocation made by the Respondent of attributing 41.523 per cent of the corporation's 1948 earnings and profits to the stockholders' calendar year 1947, and 58.477 per cent thereof to their calendar year 1948.

V.

The Record Does Not Support the Court's Finding That a Loan of the Corporation to Its Officers Was in Substance a Dividend.

Classification of stockholder withdrawals as loans or as dividends is a question of fact. *Victor Shaken* (1954), 21 T. C. 785; *Al Goodman, Inc.* (1954), 23 T. C. No. 39; *M. Jackson Crispin* (1935), 32 B. T. A. 151.

Petitioner Gene Clark purchased a farm for the intended benefit of Gene Clark, Inc. in 1946 and made a down payment of $10,000.00 which he had borrowed from Valley Cities Supply Company [R. 350-351].

Mr. Clark returned to California and at a Directors Meeting of Gene Clark, Inc. held on July 22, 1946, reported to the meeting "that on his recent trip to the State of Kansas he had purchased for the corporation, subject to its acceptance or rejection, approximately 400 acres of acreage in the County of Montgomery, State of Kansas, for the total purchase price of $40,000.00, and that he had paid the sum of $10,000.00 as the initial down payment" [Ex. 26; R. 344]. After Mr. Clark had made the initial payment, he learned the corporation could not own land in Kansas and the corporation directors thereupon rejected the proposed purchase [R. 343-344]. Mr. Clark felt the farm land was quite a good buy and he made arrangements to purchase it himself [R. 343]. At the meeting of July 22, 1946, the directors of Gene Clark, Inc. authorized a loan to Gene Clark and Archie Koyl of $21,250.00 [Ex. 26].

Under date of July 31, 1946, an account was opened on the books of the corporation designated "Notes Receivable, Account #110" and the first loan to Clark and Koyl was made in the amount of $10,000.00 [Ex. 19].

After the purchase of "North Farm", another farm was purchased, designated "South Farm", and placed in the name of Archie Koyl [Ex. 25, R. 345]. In connection with the farm purchases, a charge to "Notes Receivable" in the amount of $11,406.80 was made on August 31, 1946, and a charge of $12,420.66 was made on October 31, 1946 [Ex. 19].

Notes receivable in the total amount of $36,149.29 [Ex. 19] did not constitute a dividend to the stockholders of Gene Clark, Inc. in 1946 or in any other year. There was no surplus or income in the calendar year 1946 out of which a dividend could be paid. The evidence shows that the stockholders always considered the notes as their personal obligations. In an unquestionable arms-length transaction, when Archie Koyl sold his stock in Gene Clark, Inc. to Gene O. Clark on March 29, 1948, a part of the consideration was that Gene O. Clark assume Archie Koyl's obligation to the corporation in the amount of $10,844.79 [Ex. 29, R. 346-348]. Later on, April 29, 1948, Gene O. Clark paid off $20,000.00 of Notes Payable [Ex. 19].

VI.

The Respondent Did Not Sustain His Burden of Proof to Prove Fraud.

The Respondent has the burden of proof under the fraud issue, Section 1112 of the Internal Revenue Code of 1939; Section 7454(a) of the Internal Revenue Code of 1954.

Fraud must be established by clear and convincing proof, and a mere preponderance of evidence does not discharge this burden. *Elsye Leiser* (1952), P-H Memo. T. C. Par. 52,276, accord *Griffiths v. Commissioner* (7th Cir., 1931), 50 F. 2d 782; 10 A.F.T.R. 106; *L. Schepp Company* (1932), 25 B. T. A. 419.

Mere suspicion is insufficient proof of fraud. *Elsye Leiser, supar; Sharpsville Boiler Works Co.* (1926), 3 B. T. A. 568; *Nicholas Roerich* (1938), 38 B. T. A. 567, aff'd (1940), 115 F. 2d 39.

In *J. William Schultze v. Commissioner* (1929), 18 B. T. A. 444, the facts revealed that the petitioner was an admitted bootlegger, who pleaded guilty to a crime in 1923, and filed delinquent returns for the years 1923 and 1924. In holding that the petitioner was not guilty of fraud, Judge Van Fossan stated (at p. 446):

> "We may entertain whatever suspicions we choose, or infer whatever probabilities our imaginations dictate, but to find a man guilty of fraud requires more than suspicion or mere probabilities of dereliction. It requires evidence from which an intent to defraud and the fact of defrauding appear."

As is pointed out in the *Elsye Leiser* case, *supra,*

> ". . . (I)n this proceeding, the question of fraud is so intertwined with the alleged receipt of payments by Castleman that the respondent's burden necessarily involves proof that Leiser received all or part of the alleged payments of $72,370.00."

Similarly in this case, the question of fraud is so intertwined with the alleged receipt and diversion of moneys of the corporation to the Petitioners' own benefit that the Respondent's burden necessarily involves proof that Petitioners received and retained all or part of the alleged payments.

In the instant case, the Respondent did not come forth with any proof that the taxpayers retained any of the alleged income purportedly received by them. The Revenue Agent never interviewed the Petitioners [R. 305], analyzed

their bank accounts, or prepared net worth statements [R. 314-315]. Contrariwise, Gene Clark testified that whenever he took cash from the corporation or cashed checks belonging to the corporation, that such moneys were used to purchase materials for the business, and the corporation eventually ended up with the benefit of all the transactions [R. 330-332, 393]. Also see, testimony of Fred Files [R. 266-268].

It is abundantly clear from the record that Gene Clark was not acquainted with the niceties of determining income from the varied and sometime complicated transactions he entered into [R. 363-368]. He left the accounting phase of the business to his accountant, Fred Files [R. 334].

Evidence that a taxpayer has acted ignorantly, but without intent to defraud does not justify the imposition of the penalty for fraud. *George L. Rickard v. Commissioner* (1929), 15 B. T. A. 316; *W. F. Shawver Co. v. Commissioner* (1930), 20 B. T. A. 723.

Respondent must show that some part of the deficiencies for each year was due to fraud. *L. A. Meraux v. Commissioner* (1938), 38 B. T. A. 200; *Russell C. Mauch v. Commissioner* (1937), 35 B. T. A. 617, aff'd (3rd Cir., 1940) 113 F. 2d 555.

It is true that Respondent introduced some evidence that Gene Clark, Inc. did not report all of its income. Evidence of unreported corporate income does not prove a taxpayer stockholder received such unreported amounts. The only individual transaction in the record is the "Y. L. Creed transaction". It appeared from the testimony of Y. L. Creed that Petitioner performed plumbing work for four of his houses and that he, Mr. Creed, paid Petitioner $544.00 in February, 1946; and the balance of $2,378.50

was allowed as a credit outside of escrow on a house he had sold to Gene Clark in June, 1946 [R. 215-218; Exs. "O", "P"]. The credit was not reported on Petitioners' income tax return. The Tax Court stated in regard to this item [R. 129]:

> "If the Creed item were considered as an isolated factor, we would be unwilling to hold that the failure to report it for income tax purposes was sufficient to establish fraud, since it might have been an oversight."

A review of the record reveals that the remainder of Respondent's fraud case is based solely upon suspicion and that he has not proved by clear and convincing evidence that Petitioner Gene Clark knowingly and wilfully received and retained for his own use income that was not reported on his returns for either of the years involved.

VII.

The Respondent Has Not Sustained His Burden of Proof in Regard to Affirmative Allegations in His Answer. Hence the Statute of Limitations Precludes any Deficiency to Petitioners.

As stated above, Respondent has not met his burden of establishing fraud as to Petitioner Gene O. Clark by clear and convincing evidence. The fraud issue in respect to Petitioner Faye Clark is not in issue as Respondent conceded that her returns were not fraudulently filed [R. 53].

We are here concerned only with the Statute of Limitations, with respect to the separate returns of Petitioner Gene Clark for the years 1946 and 1947 and Petitioner Faye Clark for the year 1947. The Court found that the assessment and collection of taxes was barred as to Faye Clark for the year 1946 [R. 142].

If Petitioner Gene O. Clark's return for the year 1946 was not fraudulent, the assessment and collection of taxes for the year 1946 would also be barred as the deficiency notice was mailed to Petitioner more than five years after he filed his return (Sec. 275(c), U. S. C. A., Title 26 (1939 Ed.), [R. 142].)

Respondent relies upon Section 275(c) of the Internal Revenue Code of 1939 which provides for a five year statute of limitations to keep the year 1947 open. This section is applicable only if a taxpayer omits from gross income an amount properly includible therein in excess of twenty-five per cent of the gross income stated in his or her return.

The application of Section 275(c) is raised by Respondent in his Answer, and as a consequence, the burden of proof is upon him. *Lois Seltzer* (1952), 21 T. C. 398; *Rules of the Tax Court No. 32*

The gross income stated on each of Petitioner's returns was $9,130.51 for the year 1947. Twenty-five (25%) per cent of this amount equals $2,282.63. Exhibits "D" and "E" reveal that the maximum amounts of gross income that could have been unreported by each of the Petitioners for the year 1947, based upon the record of this case, was $953.66.

Exhibits "D" and "E" themselves are not based upon the evidence in this case, but only show maximum amounts based upon Respondent's own Revenue Agent's Reports and deficiency notices.

There is not in fact any evidence the Petitioners received and retained for their own use and enjoyment income other than was reported on their returns for the year 1947.

Section 275(a) of the Internal Revenue Code of 1939 is, therefore, applicable and the assessment of the deficiency determined by the Respondent against Petitioners for the year 1947 is barred by the Statute of Limitations.

CONCLUSION.

It is evident from the record of this case that the arbitrary determination of Respondent must be disregarded.

On the basis of the evidence introduced at the trial, the Tax Court should be reversed and the case remanded to said Court with directions to enter judgment for Petitioners.

Dated: September 17, 1958.

Respectfully submitted,

Baird & Holley,

By Thomas A. Baird,

Attorneys for Petitioners on Review.

APPENDIX.

Exhibit A.

BALANCE SHEET OF GENE CLARK, INC., AT MAY 1, 1946, SET FORTH IN THE TAX RETURN OF SAID CORPORATION [EX. 12-L, OFFICIAL TRANSCRIPT, PAGE 22].

ASSETS	
Cash on Hand	$ 7,583.10
Accounts Receivable	27,733.77
Inventory	19,623.35
Trucks and Equipment	18,827.56
Buildings and Leasehold	9,732.62
Office Equipment	1,139.77
Land	3,045.00
Deferred Charges	1,523.95
Organization Expense	457.50
	$89,666.62

LIABILITIES	
Notes Payable	$ 5,000.00
Accounts Payable	23,585.05
Reserve for Depreciation	3,351.59
Accrued Taxes and Insurance	2,961.66
Accrued Salaries	2,568.32
Capital Stock	52,200.00
Surplus	—0—
	$89,666.62

Exhibit B.

BALANCE SHEET OF GENE CLARK, INC., AT APRIL 30, 1947, BASED UPON THE TAX RETURN OF SAID CORPORATION, AS ADJUSTED BY ADDITIONS AND CONCESSIONS OF THE COMMISSIONER OF INTERNAL REVENUE IN HIS REVENUE AGENT'S REPORT OF GENE CLARK, INC. [EXHIBITS 12-L AND 3-C, RESPECTIVELY AND OFFICIAL TRANSCRIPT, PAGES 20 AND 23, RESPECTIVELY].

ASSETS		
Cash		$ 41,693.47
Accounts Receivable		23,994.79
Inventory		18,963.81
Other Investments		24,862.10
Fixed Assets		
Trucks and Equipment	$33,375.00	
Buildings and Leasehold	10,205.50	
Office Equipment	1,765.64	
	$45,346.14	
Less: Reserve for Depreciation	9,672.51	35,673.63
Land		3,045.00
Due from Officers		39,914.07
Organization Expense		457.50
Deferred Charges		989.97
		$189,594.34
LIABILITIES		
Accounts Payable		$ 28,697.64
Trust Deed		10,798.45
State Income Tax		2,424.97
Federal Income Tax		50,419.26
Accrued Taxes and Insurance		1,529.89
Accrued Salaries		2,357.24
Reserve for items not available for distribution		
Truman Johnson transaction	$ 6,000.00	
H. L. Brittian Item	1,860.40	
Reversal of Deferred Income	49,210.15	
Merchandise Account	2,714.42	
Bad Debts	3,703.50	63,488.47
Capital Stock		52,200.00
Surplus (Deficit)		(19,787.16)
		$189,594.34

Exhibit C.

BALANCE SHEET OF GENE CLARK, INC., AT APRIL 30, 1948, BASED UPON THE TAX RETURN OF SAID CORPORATION, AS ADJUSTED BY ADDITIONS AND CONCESSIONS OF THE COMMISSIONER OF INTERNAL REVENUE IN HIS REVENUE AGENT'S REPORT OF GENE CLARK, INC. [EXHIBITS 13-M AND 3-C, RESPECTIVELY AND OFFICIAL TRANSCRIPT, PAGES 23 AND 20, RESPECTIVELY].

ASSETS		
Cash		$ 29,978.35
Accounts Receivable		17,421.59
Inventory		8,332.24
Fixed Assets		
Trucks and Equipment	$19,911.60	
Buildings and Leasehold	13,664.44	
Office Equipment	3,416.29	
Less: Reserve for depreciation	11,947.58	25,044.75
Organization Expense		457.50
Deferred Charges		1,037.22
Trust Deeds		27,518.99
		$109,790.64
LIABILITIES		
Accounts Payable		$ 10,565.70
Dividend Payable		20,000.00
Federal Income Tax		82,803.93
Fraud Penalty for fiscal year 1947		21,942.94
Accrued Taxes and Insurance		1,242.70
Reserve for Items not available for distribution		
Advance on Contract Sales	$ 5,080.40	
Ben Lang Item	1,300.75	6,381.15
Capital Stock		52,200.00
Surplus (Deficit)		(85,345.78)
		$109,790.64

Exhibit D.

A COMPUTATION REFLECTING THE MAXIMUM AMOUNT OF EARNINGS AND PROFITS AVAILABLE AS A DIVIDEND DISTRIBUTION TO THE PETITIONERS, GENE CLARK AND FAYE CLARK, FOR THE CALENDAR YEARS 1946 AND 1947, FROM THE NET INCOME OF GENE CLARK, INC., FOR THE FISCAL YEAR ENDING APRIL 30, 1947.

Net income per income tax return	[R. 91]		$ 30,632.10
Adjustments to net income	[R. 91]		102,050.17
Adjusted net income	[R. 91]		$132,682.27
Deduct:			
Y. L. Creed transaction	[R. 91]	$ 3,058.50	
Cashing accommodation checks	[R. 91]	1,480.67	4,539.17
Earnings and Profits Available for Distribution	[R. 91]		$128,143.10
Deduct:			
Accrued Federal Income Tax	[R. 91]	$48,694.38	
Items not available for distribution in the fiscal year April 30, 1947	[Ex. 3-C]	63,488.47	112,182.85
Maximum Amount of Earnings and Profits Available for Distribution			$ 15,960.25

ALLOCATION OF EARNINGS AND PROFITS BETWEEN CALENDAR YEARS 1946 AND 1947.

Gene Clark)			$ 5,586.09
Faye Clark)	70%	[R. 85]	5,586.09
Archie Koyl	30%	[R. 85]	4,788.07
			$15,960.25

Gene Clark and Faye Clark's percentage of earnings and profits applied to the calendar year 1946—84.259% [R. 85]

Gene Clark and Faye Clark's percentage of earnings and profits applied to the calendar year 1947—15.741% [R. 85]

Gene Clark— Calendar year 1946—$5,586.09 x 84.259% =$	4,706.78
Faye Clark— Calendar year 1946— 5,586.09 x 84.259% =	4,706.78
Gene Clark— Calendar year 1947— 5,586.09 x 15.741% =	879.31
Faye Clark— Calendar year 1947— 5,586.09 x 15.741% =	879.31

Footnote:

The computation set forth above is based upon the Revenue Agent's Report of Gene Clark, Inc. [Exhibit 3-C] which was stipulated to be the basis of Petitioners' deficiency notices, as adjusted by specific findings of the Tax Court as amplified by legal principles adopted by the Tax Court.

Exhibit E.

A COMPUTATION REFLECTING THE MAXIMUM AMOUNT OF EARNINGS AND PROFITS AVAILABLE AS A DIVIDEND DISTRIBUTION TO THE PETITIONERS, GENE CLARK AND FAYE CLARK, FOR THE CALENDAR YEAR 1947, FROM THE NET INCOME OF GENE CLARK, INC., FOR ITS FISCAL YEAR ENDING APRIL 30, 1948.

Net Income per income tax return	[R. 114]		$ 16,726.40
Adjustments to net income	[R. 114]		92,208.62
Adjusted net income	[Ex. 3-C]		$108,935.02
Deduct:			
Substituted deposits	[R. 117]	$ 3,432.48	
Pacific Pumps, Inc.	[R. 115]	1,094.52	4,527.00
Earnings and Profits Available for Distribution	[R. 122]		$104,408.02
Add:			
Items not available for distribution in fiscal year ending April 30, 1947, but available for distribution in the fiscal year ending April 30, 1948	[Ex. 3-C]		63,488.47
			$167,896.49
Deduct:			
Transactions which the Revenue Agent's Report manifests, occurred in the calendar year 1948	[Ex. 3-C]	$77,207.15	
Dividend declared April 30, 1948	[Ex. 3-C]	20,000.00	
Accrued Federal Income Tax		39,675.05	
Fraud Penalty for fiscal year April 30, 1947		21,080.50	
Accrued interest on Assessed Tax and Penalty		3,041.05	
Items not available for distribution at April 30, 1948	[Ex. 3-C]	6,381.15	167,384.90
Maximum Amount of Earnings and Profits Available for Distribution			$ 511.59

ALLOCATION OF EARNINGS AND PROFITS.

Gene Clark)			$ 179.06
Faye Clark)	70%	[R. 85]	179.06
Archie Koyl	30%	[R. 85]	153.47
			$ 511.59

ALLOCATION BETWEEN CALENDAR YEARS 1947 AND 1948.

1947	41.523%	[Ex. 3-C]
1948	58.477%	[Ex. 3-C]
	100%	

Gene Clark—Calendar year 1947—$179.06 x 41.523% = $74.35

Faye Clark—Calendar year 1947—$179.06 x 41.523% = 74.35

Footnote:

The computation set forth above is based upon the Revenue Agent's Report of Gene Clark, Inc. [Exhibit 3-C] which was stipulated to be the basis of Petitioners' Deficiency Notices, as adjusted by specific findings of the Tax Court as amplified by legal principles adopted by the Tax Court.

Exhibit F.

TRANSACTIONS WHICH THE REVENUE AGENT'S REPORT MANIFESTS, OCCURRED IN THE CALENDAR YEAR 1948 [EXHIBIT 3-C].

SUBSTITUTED DEPOSITS

Date of Deposit	ABA Number of Item	Unreported Item of Income
January 7, 1948	90-1399	$ 121.41
January 14, 1948	16-312	136.00
	16-312	1,165.00
	90-1051	140.73
	16-274	64.00
January 10, 1948	90-975	45.00
	90-453	2-77
	16-281	20.50
	90-1111	4.30
	90-1181	58.94
	90-1342	6.95
February 16, 1948	90-934	1,094.52
March 4, 1948	90-1075	307.81
March 13, 1948	90-1320	200.00
	1-23	111.00
March 18, 1948	90-499	5.00
	90-1075	87.50
	90-1075	56.20
	90-499	60.00
	90-177	24.75
	90-928	78.74
March 31, 1948	90-1448	6,670.00
April 9, 1948	11-75	100.00
	90-1305	228.67
	90-1305	213.32
	90-1305	261.34
	90-1305	215.95
April 16, 1948	90-1109	25.00
		11,775.40

Less:			
Allowed by Tax Court for cashing accommodation checks	[R. 117]	$1,177.54	
Pacific Pumps, Inc.	[R. 115]	1,094.52	2,272.06
			$ 9,503.34

Footnote:

The Tax Court made a ten percent reduction in substituted deposits to make allowance for cashing accommodation checks. [R. 117.] Net substitutions for the fiscal year April 30, 1948, amounted to $34,324.84 [Exhibit 3-C]. Of this sum, $22,549.44 represented calendar year 1947 transactions, and $11,775.40 represented calendar year 1948 transactions; therefore, the sum of $11,775.40 has been reduced by ten percent, or $1,177.54.

Unreported Income Items in Other Bank Accounts, as Alleged in Exhibit 3-C

Date of Deposit	ABA Number of Item	Amount of Item
January 17, 1948	90-1404	$ 630.00
January 26, 1948	90-1404	630.00
	90-1131	1,902.73
	90-1111	133.95
January 27, 1948	90-994	1,400.00
	90-180	276.75
February 9, 1948	90-1305	22,935.00
Fawn Koyl, Trustee for David T. Koyl, Term Account No. 15,713		
Citizens National Bank, Maywood Branch		
February 16, 1948		200.00
Fawn Koyl, Trustee for Rodney S. Koyl, Term Account No. 21268		
Citizens National Bank, Maywood Branch		
February 16, 1948		700.00
Archie Koyl		
Citizens National Bank, Maywood Branch		
January 9, 1948	90-180	92.15
	15-51	100.00
January 22, 1948	90-1051	200.00
	90-1344	154.87
January 26, 1948	90-938	170.00
	90-1075	700.00
February 2, 1948	90-1051	863.00
	90-242	58.60
March 15, 1948	90-960	122.59
March 18, 1948	90-903	100.00
	90-1075	109.75
Clyde R. Clark Farm Account		
Independence State Bank, Independence		
January 31, 1948		3,074.74
		500.00
Archie Koyl		
Bell Gardens Bank, Bell Gardens		
January 12, 1948	90-1419	600.00
January 22, 1948	90-1075	1,055.50
February 2, 1948	90-1419	850.00
Mrs. Gene Clark		
Covina National Bank, Covina		
January 23, 1948		467.95
February 9, 1948		693.13
April 30, 1948		112.83
		242.15
		225.18
		$39,300.87

Gain or Loss Computed on Sale of Capital Assets
Exhibit G of Exhibit 3-C

Date of Sale	Asset Sold	Loss on Sale	Gain on Sale
February 17, 1948	Craftsman Drill		$ 60.00
February 7, 1948	Asset unknown		478.00
February 1, 1948	GMC Pickup		518.27
February 1, 1948	Chev. Pickup	$ 42.19	
February 1, 1948	Int. Pickup	7.81	
February 1, 1948	Chev. Pickup	72.67	
February 1, 1948	Chev. Pickup	76.43	
February 1, 1948	GMC Pickup		625.20
March 1, 1948	Chev. 4 Dr. Sedan	143.54	
April 30, 1948	Chev. Pickup		53.65
April 30, 1948	Chev. Pickup		230.07
April 30, 1948	Chev. Pickup		412.66
April 30, 1948	Chev. Pickup		209.88
		342.64	2,587.73
			342.64

Gain on Sale of Assets in calendar year 1948		$2,245.09
April 30, 1948	Advance on Contract Sales	5,080.40

Other Items of Unreported Income—Schedule 3 of Exhibit 3-C

January 9, 1948	Allen T. Mitchell & Son	$2,294.50
February 10, 1948	A & F Plumbing & Heating	2,223.76
March 2, 1948	Valley Boulevard Plumbing and Electric Co.	12,000.00
April 21, 1948	Ben Lang	1,558.44
April 30, 1948	Ben Lang (Contra item)	1,300.75
February 12, 1948	Sale of Truck [Exhibit Y]	1,700.00
		$21,077.45

SUMMARY

Substituted Deposits	$ 9,503.34
Unreported Income Items in Other Bank Accounts	39,300.87
Gain on Sale of Assets	2,245.09
Advance on Contract Sales	5,080.40
Other Items of Unreported Income	21,077.45
Total	$77,207.15

INTERNAL REVENUE CODE OF 1939.

Section 115 * * *

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201(c)(5), section 204(c)(11) and section 207(a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504(c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:

(1) The net operating loss credit provided in section 26(c)(1);

(2) The dividend carry-over provided in section 27(c); and

(3) The deduction for amounts for retirement of indebtedness provided in section 504(b).

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113. The preceding sentence shall not apply to a distribution which is a dividend within the meaning of the last sentence of subsection (a).

*   *   *   *   *   *   *   *   *

(d) *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f)(1), is not treated as a dividend, whether or not otherwise a dividend.

Section 275 * * *

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

*   *   *   *   *   *   *   *   *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

Section 276 * * *

(a) *False Return or No Return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

Section 293 * * *

(b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).

INTERNAL REVENUE CODE OF 1954.

Section 7454 * * *

(a) *Fraud.*—In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate.

Treasury Regulations 111, Promulgated Under the Internal Revenue Code of 1939.

Section 29.115-2

For the purposes of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given first, to the earnings of profits of the taxable year; second, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; third, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend.[2] (See section 29.115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of

the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. The provisions of this section may be illustrated by the following example:

Example.—At the beginning of the calendar year[3] 1942, the Corporation had $12,000 in earnings and profits accumulated since February 28, 1913, the earnings and profits for[3] 1942 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively,

were paid out of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year as follows:

Distribution during[3] 1942 Date	Amount	Portions out of earnings or profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913 and prior to taxable year	Taxable amount of each distribution
Mar. 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
Sept. 10	15,000	7,500	....	7,500
Dec. 10	15,000	7,500	....	7,500
Total amount taxable as dividends				$42,000

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Chapter 1.

Rules of Practice of the Tax Court of the United States.

Rule 14, Answer.

(a) *Time to answer or more.*—The Commissioner, after service upon him of the petition, shall have 60 days within which to file an answer or 45 days within which to move with respect to the petition. (See Rule 22(a) re service of answer.)

(b) *Form of answer.*—The answer shall be drawn so that it will advise the petitioner and the Court fully of the nature of the defense. It shall contain a specific admission or denial of each material allegation of fact contained in the petition and a statement of any facts upon which the Commissioner relies for defense or for affirmative relief or to sustain any issue raised in the petition in respect of which issue the burden of proof is, by statute, placed upon him. Paragraphs of the answer shall be numbered to correspond to those of the petition to which they relate. The original shall be signed by the Commissioner or his counsel.

(c) *Copies and conformation.*—The original and 3 copies of the answer shall be filed, and each copy shall be conformed.

(d) *Application of Rule to amended answers.*—This Rule shall apply to the filing of answers to amended petitions and to amendments to petitions, except as the Court in a particular case may otherwise direct.

Rule 32. Burden of Proof.

The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent.

* * * * * * * * *

EXHIBITS. References are to page numbers in the Official Transcript of Record.

Petitioners' Exhibits	Identified	Offered	Received
1-A—RAR Gene O. Clark	19	19	20
2-B—RAR Gene O. and Faye Clark	19	19	20
3-C—RAR Gene Clark, Inc.	19	19	20
4-D—1945 Return Gene O. Clark	21	21	21
5-E—1946 Return Gene O. Clark	21	21	21
6-F—1947 Return Gene O. Clark	21	21	21
7-G—1945 Return Faye Clark	21	21	21
8-H—1946 Return Faye Clark	21	21	21
9-I—1947 Return Faye Clark	21	21	21
10-J—1948 Return Gene O. Clark and Faye Clark—also amended return	22	22	22
11-K—1949 Return Gene O. and Faye Clark	22	22	22
12-L—1947 Return Gene Clark, Inc.	23	23	23
13-M—1948 Return Gene Clark, Inc.	23	23	23
14-N—1949 Return Gene Clark, Inc.	23	23	23
15—Gene Clark, Inc. Fiscal 1947 —Analysis of Income Available for Distribution to Stockholders Based on Report of RA, D. E. Phillips	26	39	39
16—Fiscal 1947 Gene Clark, Inc. Comparative Analysis of Surplus Based Upon Report of Examination by RA Don E. Phillips and 90 day letter showing Amount Available for Distribution as a Constructive Dividend	39	51	51

Petitioners' Exhibits	Identified	Offered	Received
17—Gene Clark, Inc. Balance Sheets	56	56	56
18—Gene Clark, Inc. Disposition of Income Reported in Return Fiscal Year April 30, 1947	59	59	59
19—General Ledger (4 sheets) Record of Journal Entries (3) sheets)	159	159	159
20-WW—RAR Gene Clark, Inc.	183	183	183
21-XX—Cash Receipts Unidentified FYE 1950 Gene Clark, Inc.	185	185	185
22-YY—Cash Receipts Unidentified FYE 1949 Gene Clark, Inc.	185	185	185
23-ZZ—Cash Receipts Unidentified FYE 1948 Gene Clark, Inc.	185	185	185
24-AAA—Cash Receipts Not Located in Deposits FYE 1947 Gene Clark, Inc.	185	185	185
25—Map	256	256	256
26—Minutes (10 Sheets)	258	259	259
27—Agreement dated Jan. 28, 1949	262	263	264
28—Affirmation of Sale	262	263	264
29—Assumption of Obligation 3-29-48	269	269	269
30—Note 98077 2/5/48	314	315	315
31—Note 98076 2/5/48	314	315	315
32—Check 4602 $450.00	357	357	357
33—Check 4605 $102.15	358	358	358
34—Check 4606 $274.95	359	359	359
35—Check 4607 $50.00	361	361	361
36—Check 4608 $50.00	362	362	362
37—Check 4609 $50.00	363	363	363
38—Check 4610 $20.00	364	364	364

Petitioners' Exhibits	Identified	Offered	Received
39—Check 4612 $50.00	364	364	364
40—Check 4613 $50.00	365	365	365
41—Check 4614 $195.57	366	366	366
42—Check 4615 $50.00	366	366	366
43—Check 4616 $50.00	367	367	367
44—Check 4617 $50.00	368	368	368
45—Check 4618 $36.50	369	369	369
46—Check 4619 $590.36	371	385	386
47—Check 4620 $50.00	371	371	371
48—Check 4603 $50.00	372	372	372
49—MFI (offered but not admitted (Income Tax Schedule))	374	374	......
50—Check 4621 $50.00	377	377	377
51—Check 4622 $85.00	378	378	378
52—Check 4623 $50.00	379	379	379
53—Check 4624 $50.00	379	379	379
54—Check 4627 $50.00	380	380	380
55—MFI only	382	383	......
56—Receipt Montgomery Taxes	382	383	385
57—Cert. of Payments and Assessment (3 sheets)	391	391	391

Respondent's Exhibits			
O—Affidavit of Y. L. Creed	69	72	73
P—Check No. 11 Y. L. Creed	70	70	70
Q—Plumbing Contract	76	79	79
R—Plumbing Contract	76	79	79
S—Check 3008 Ben Lang	85	86	86
T—Invoice (2) Ben Lang	85	86	86
U—Check No. 1534 Hamilton Homes, Statement dated 8/14/47 Invoice 8/14/47	88	88	88
V—Check No. 1476 Hamilton Homes Statement 7/9/47	88	88	88
W—Check No. 1539 Hamilton Homes, Invoice dated 2/11/47, Invoice dated 8/26/47, Heaters on Tract Invoice 9/9/46, Invoice 8/29/46	88	88	88
X—Check No. 52, 68, Invoice Sept. 10, 1947	94	97	97
Y—Check No. 3787	94	97	97
AA—Checks 2936, 212, 3351, 3696, 4587, 659, 581, Valley City Supply Co. Invoice 3351, 3696, 4587, 442, 212, Statement Invoice 1/16/47, Invoice 1/18/47, Valley City Supply Invoice—Delivered to Valley Cities	95	98	98
BB—Check No. 537807, Check No. 537806, Check No. 392991, 394131, 395227, 392653	95	98	98
CC—Check No. 2313 Mitchell & Son	95	98	99
DD—Check No. 866, Invoice Jan. 21, 1948	95	98	98